

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Wildman & Kuehl Analyst: Jeani Brent Bill Number: AB 358

Related Bills: See Prior Analysis Telephone: 845-3410 Amended Date: 07/14/1999

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Refundable Credit/Qualified Wages and Salaries Paid for Production of or Musical Scoring for Qualified Television Program or Motion Picture

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced February 11, 1999 and amended May 28, 1999, and July 1, 1999.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 11, 1999, AND AS AMENDED May 28, 1999, and July 1, 1999, STILL APPLY.

X OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would provide a refundable credit equal to 10% of qualified wages and salaries paid to employees and contractors retained by the taxpayer in connection with the production of or musical scoring for a television program or motion picture for which at least 75% of the total production labor costs or principal photography occurs in California.

This bill also would require the department to report annually to the Legislature on the total amount of credits claimed under the bill and would require the Employment Development Department (EDD) to report annually to the Legislature employment data for Standard Industrial Classification Code 781 (relating to motion picture and videotape production). The provisions regarding EDD are not discussed in this analysis.

SUMMARY OF AMENDMENT

The July 14, 1999, amendments added a provision that would disallow the credit for any taxable or income year during which the amount of monetary credits or rebates offered by the Canadian government for motion picture or television productions is reduced below the amount provided during 2000. The amendments also changed the sunset date from January 1, 2005, to January 1, 2003; removed the requirement that to be qualified, wages must be paid to a California resident; and corrected a typographical error.

The July 14, 1999, amendments resolved the two implementation considerations relating to the residency requirement of employees, but did not resolve the remaining policy, implementation, or technical considerations addressed in the department's analysis of the bill as amended July 1, 1999. In addition, the July 14, 1999, amendments raise an additional implementation consideration, identified

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> X PENDING

Legislative Director

Date

Johnnie Lou Rosas

8/11/1999

as #5 below. Except for the items discussed in this analysis, the department's analyses of the bill as introduced February 11, 1999, and as amended May 28, 1999, and July 1, 1999, still apply. The department is working with the author's staff and sponsors to resolve the implementation and technical considerations addressed in this analysis.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately and specifies that it would apply to taxable or income years beginning on or after January 1, 2000, and before January 1, 2003.

POLICY CONSIDERATIONS

This bill would raise the following policy considerations.

1. This bill generally would limit the credit to only wages and salaries paid in connection with a "qualified television program or qualified motion picture." However, this bill would not tie wages and salaries paid for musical scoring sessions to a qualified television program or motion picture. Thus, wages and salaries paid for any musical scoring session that involves 25 or more instrumentalists would qualify. However, the bill would limit qualified wages for musical scoring sessions to \$1.5 million for a single taxpayer in any taxable or income year.
2. Conflicting tax policies come into play whenever a credit is provided for an expense item for which preferential treatment already is allowed in the form of an expense deduction or depreciation deduction. This bill would have the effect of providing a double benefit for deductible wages and salaries. On the other hand, making an adjustment to limit deductions or reduce basis in order to eliminate the double benefit creates a state and federal difference, which is contrary to the state's general federal conformity policy.
3. Under this bill, if taxpayers elect to take this credit, it would be in lieu of any other credit allowed for the same costs. However, recent legislation has replaced the requirement that taxpayers make an election for those expenditures with a provision limiting the taxpayer to only one credit with respect to qualified expenditures. This change allows taxpayers to make the choice of which credit to take on either the original or an amended return. This change was made because the requirement for an election, as provided under this bill, was too restrictive. When an election is required, once made, it is binding and generally cannot be revoked. In addition, with an election provision, the failure to make an election generally constitutes an election out of the provision and this "non-election" is binding.

IMPLEMENTATION CONSIDERATIONS

This bill raises the following implementation considerations:

1. Historically, refundable credits (such as the state renter's credit, the federal Earned Income Tax Credit and the federal farm gas credit) have had significant problems with fraud.

2. The provisions regarding wages and salaries that are not included in "qualified wages and salaries" are unclear. The bill states wages and salaries would not qualify to the extent they exceed the lesser of twice union scale or \$23 per hour, but not less than \$300 per day, or \$7,000 per week. This provision leaves unclear how and when each of the given pay scales would interact as limits on the others. Since the three different limiting factors apparently are intended to apply to different classifications of employees, more detail should be provided to clarify the intended results. For example, it is unclear how \$7,000 could be a limiting factor, when \$23 an hour and \$300 a day are less than that amount.
3. Although previously raised implementation concerns have been addressed, the definitions provided to address these concerns use terms and phrases that appear to be industry-specific terms that have no unambiguous definition under the law, e.g. "new-use," "reuse," "clip use," "delayed or residual compensation," "turnaround," etc. If there is a "dictionary" of motion picture industry terms, it might be helpful to identify a source for these terms and to specifically tie the interpretation of these terms under this bill to those external sources.
4. This bill provides no guidance as to whether the refundable credit would be allowed to reduce alternative minimum tax to zero. Generally, credits cannot reduce the alternative minimum tax. The lack of guidance could cause disputes between taxpayers and the department.
5. Although this bill provides that the amount of credit that exceeds tax liability, after all other credits have been subtracted, would be refunded, this bill does not modify the hierarchy of PITL or B&CTL tax credits (Sections 17039 and 23036), thus the order in which credits would be applied before this credit would be refunded is unclear.
6. The department would have difficulty administering the provision that would disallow the credit for any taxable or income year during which the amount of monetary credits or rebates offered by the Canadian government for motion picture or television productions is reduced below the amount provided during 2000. The department would not have access to information by which the department readily could determine the level of the rebates and credits offered by the Canadian government. Also, this credit would commence January 1, 2000, prior to the end of the 2000 measurement period, and thus the comparative number would not be known until after the credit begins. In addition, it is not specified whether "2000" refers to the calendar year 2000.

TECHNICAL CONSIDERATIONS

This bill raises the following technical considerations:

1. The language adding the definition of "qualified wages and salaries" provides that wages can qualify even if paid to a personal service corporation or a loan-out company. The credit language in subdivision (a) refers to "qualified wages and salaries paid to employees and contractors **retained by the taxpayer in connection with.**" Reading these two provisions together, it is arguable that a loan-out company that provides employees or contractors to the actual production company may be properly treated as having "retained" those employees or contractors "in connection with" the production or musical

scoring session, with the result that both the actual production company **AND** the loan-out company would **EACH** be entitled to claim this credit with respect to the qualified wages paid (since the credit for the production company would be based on the amounts paid to the loan-out company, even if those amounts are not "wages" within the meaning of the Unemployment Insurance Code).

2. The limitation in subdivision (b)(1)(B)(iv) on the maximum amount of "qualified wages and salaries" per taxpayer may be unclear as to what happens with respect to wages paid or incurred that are not qualified in the taxable or income year paid. For example, could any wages exceeding the \$1.5 million limitation be treated as qualified wages in the ensuing taxable or income year. Language clarifying the author's intent on this uncertainty would avoid disputes between taxpayers and the department.
3. In subdivision (b)(1)(B)(iv)(I) & (II), dollar amounts are used to limit the amount of qualified wages. It is not clear whether the author intends to index these amounts for inflation.
4. Subdivision (b)(A)(2) requires that a minimum percentage of the total production labor costs be "**incurred in California**" in order for those costs to qualify for this credit. The use of the term "incurred" in this context may indicate a contractual interpretation of that term, rather than a tax law interpretation, which would mean, for example, that if a contract for production labor was executed in California, even if the services are to be performed outside California, the contract might be treated as having satisfied the "incurred in California" standard. It would be better if the amounts in question were required to be treated either as California wages under the UIC or subject to California tax in the case of contract payments.
5. The term "excess" as used in subdivision (f)(1) is unclear because of its placement AFTER the "minus other credits" phrase. It is unclear whether the excess also includes the other credits that are limited by the tentative minimum tax. If the term "minus" were replaced by "net of," and the punctuation (commas in particular) were altered, this issue could be clarified, assuming the author wants only the excess unused wage credit to be refundable.

LEGISLATIVELY MANDATED REPORTS

This bill would require the department to report annually to the Legislature on the total amount of credits claimed under this bill.

FISCAL IMPACT

Departmental Costs

Establishing a refundable credit would significantly impact the department's programs and operations since a refundable credit has not existed since the suspension of the refundable renter's credit in 1993, and the department has never administered a refundable bank and corporation tax credit. Staff preliminarily estimates that the order of magnitude of the departmental costs would be as shown in the following table:

Franchise Tax Board Order of Magnitude Departmental Costs		
	1999/00	2000/01
Personal Services (approximately 10 personnel years in first year, 2 ongoing)	580,000	133,000
Operating Expense and Equipment	85,000	21,000
Departmental overhead	53,000	12,000
Total	\$718,000	\$154,000

Tax Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Revenue Impact of AB 358, As Amended July 14, 1999 \$ Millions			
1999-0	2000-1	2001-2	2002-03
-\$3	-\$46	-\$83	-\$94

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The July 14, 1999, amendment made the following changes: (1) limited the credit to three years beginning on 1/1/2000, (2) removed the requirement that qualified contractors must be California residents, (3) disallowed the credit if the total credits granted by the Canadian national government or any Canadian provincial government drops below the level of credits granted in the year 2000. Despite these amendments, the primary reasons for the change in the revenue estimate from the previous analysis is new information that has been received from industry representatives on the following issues: the impact of the \$7,000 per week cap on wages, the percentage of wages paid for qualified shows that are continuing from a prior year, and the average duration of a qualified project. The previous version of this bill was estimated to generate revenue impacts of -\$3 million in 1999/2000, -\$49 in 2000/2001, -\$132 in 2001-2, and -\$176 in 2002-3.

The revenue impact of this credit would depend on the amount of qualified wages paid in any given year. Since the credit is refundable, total revenue losses do not depend on the existence of tax liabilities.

An estimate for the amount of wages that would qualify under this bill was provided to the department by the Film and Television Action Committee (FTAC). For the year 1998, FTAC estimates that total wages for qualified projects would be approximately \$1,429 million, about 12% of the wages paid to California employees in industry SIC 781 (Motion Picture and Video tape Production). FTAC also provided information regarding the impact of the weekly wage cap of \$7,000. Analysis of several actual projects suggested that the \$7,000 weekly cap could reduce qualified wages below total wages by more than 50%. For purposes of this estimate, it was assumed that the \$7,000 weekly cap would reduce qualified wages by 50%.

Data provided by the California Employment Development Department (EDD) reveals that the average annual growth rate of average weekly wages in SIC 78 was 6.6% for the period 1995 through 1998. This growth rate was used for projecting qualified costs for the out years of this bill. The qualified wages figure provided by FTAC grew, under this assumption, from \$1,429 million in 1998 to \$1,648 in the year that this credit would first be available, 2000. This amount was discounted to account for the requirement that qualified wages could be paid only to employees or contractors hired on or after January 1, 2000.

The revenue loss for 2000, the first taxable or income year, is projected to be \$65 million as follow:

\$1,624 mil. total wages * 50% cap adj.*76% adj.*10% credit rate = \$62 mil.

While the total qualified wages for 2000 is projected to be \$1,624, some of the employees would have been hired prior to 2000 and would not qualify for the credit. It was estimated that 76% of wages would be paid to employees hired after January 1, 2000. This estimate was derived from two considerations. First, it was assumed that 5% of qualified wages would be for ongoing projects - in particular, continuing television series. Second, it was assumed that of the new projects, 20% of the wages would have been paid to employees who were hired in 1999. Both the 5% and the 20% were derived from conversations with FTAC representatives. Thus, for the 95% of wages paid for projects that are not continuing television series, 80% would be paid to employees hired after January 1, 2000. $(.95 * .80 = .76)$ For the year 2001, all of the wages paid for new projects would be paid to employees hired after January 1, 2000.

For purposes of this estimate, it is assumed that the Canadian governments would not reduce the amount of credits allowed relative to the year 2000 during the time period for which this credit is available. If this assumption proves to be wrong, the revenue estimate for this credit would drop to zero, except for continued use of carryover of credits earned before the reduction in Canadian incentives.

BOARD POSITION

Pending.

At its March 23, 1999, meeting, the Franchise Tax Board voted 2-0 to take a neutral position on this bill as introduced. The Franchise Tax Board's position for the bill as amended July 1, 1999, is pending.